No. 11,029

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

UNITED STATES OF AMERICA,
Appellant,

vs.

LA SOCIETE FRANCAISE DE BIENFAISANCE MUTUELLE (a corporation),
Appellee.

APPELLEE'S PETITION FOR A REHEARING.

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To the Honorable Francis A. Garrecht, Presiding Judge, and to the Honorable Associate Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

The law-making body decides what the exemptions from taxation shall be, and into the wisdom or policy of such decision the courts do not inquire. The opinion disregards and nullifies the unmistakable purpose of Congress, for whose decision it, in effect, substitutes its own view as to whether nonprofit hospitals such as appellee's should receive exemption.

The opinion also fails to distinguish between appellee's "*purposes*" and the *means* by which such pur-

poses are realized, that is, it treats the *means* by which it derives income to promote the *"purposes"* which are made the basis for the exemption, as if those *means* were, in and of themselves, ends or objectives.

The opinion seemingly states that the trial court found that appellee "was organized and operated exclusively for charitable purposes". What it found (R. 54) was, that it was a "charitable corporation *within the meaning"* of the relevant sections of the Act. The controlling question is not whether appellee, as a nonprofit hospital, is a charitable corporation *generally,* (though we believe it to be such), but whether *Congress* considered such hospitals to be charitable and intended to exempt them.

Also, in every essential particular, the opinion is directly opposed to *Better Business Bureau v. United States,* 60 S. Ct. 112. Thus:

1. The opinion there states that the *"legislative history"* showed that the Bureau was not exempt; that "Congress has made it clear from its *committee reports",* what were to be excluded; that thereby it has made an *"unmistakable* demarcation" between exempt institutions and others and has shown what was its *"manifest* desire"; that, when it later amended the act, its *"committee report* referred specifically" to designated organizations, and that the administrative definition is "highly relevant and material evidence of the probable general understanding of the times *and of the opinions of men who probably were active in the*

drafting of the statute." This latter language peculiarly applies to the action of a *conference committee* at the final and critical stage of the enactment of legislation.

Here, however, the opinion completely ignores this basic and every-day aid to construction which, if observed, is decisive.

2. The opinion there states that "no part of its net earnings inures to the benefit of any private shareholder or individual"; that, regardless of whether its operations are properly characterized as "educational", "an *important if not its primary pursuit*" is to "promote" a profitable *business* community; that there is "a *commercial* hue permeating it", and that its "activities are largely animated by this *commercial purpose.*" (Emphasis ours). In other words, the Bureau's *ends* are *commercial,* just as in *Northwestern Municipal Association v. United States,* 99 Fed. (2d) 460, where it was held to be a "mere adjunct" of private institutions for profit.

The *converse* here is true. Appellee's sole *end* or *purpose* is the *protection of health.* All its income, from whatever source, is "*mediate* to the *primary purpose*", (per L. Hand, J., in *Slee v. Commissioner,* 2d Circ., 42 Fed. (2d) 184.

3. The opinion there states:

> "In order to fall within the claimed exemption, an organization must be devoted to educational *purposes* exclusively. This plainly means that the

> presence of a single non-educational *purpose,* if substantial in nature, will destroy the exemption * * * an important if not the *primary pursuit* of petitioner's organization is to *promote* not only an ethical but also a profitable *business* community." (emphasis ours)

The record (Cong. Rec., Vol. 79, Part 10, pp. 11,321, 11,323, amendments Nos. 15 and 81) shows:

> "The Senate amendment adds to the list of purposes *'or hospital'* as a clarifying amendment. The Senate recedes, the conferees omitting this language as *surplusage,* based on the fact that the Internal Revenue Bureau has uniformly construed language in the income tax laws, identical with that found in the house bill, *as exempting hospitals not operated for profit,* and also on the fear that the insertion of the words added by the Senate amendment might interfere with the long-continued construction of the income tax law."

We submit that the intention of Congress could not more unmistakably have been shown. Necessarily, therefore, *the Act must be read as if its language were,* "religious, charitable, scientific, literary, or educational, OR HOSPITAL, purposes", for this is precisely what Congress *understood and intended.*

Also, the Conference Committee report ITSELF CONSTRUES THE CLAUSE, "no part of the net earnings of which inures to the benefit of any private shareholder or individual", as *inapplicable to nonprofit hospitals.* This is evidently so. Since the

report intended to exempt all "hospitals not operated for profit", it necessarily considered that their earnings do *not* inure to private gain.

The Bureau of the Census report* states that, in 1939, there were in this country 6,991 hospitals, which it classifies as:

"Proprietary"	2,295	32.82 per cent
"Government"	1,729	24.74 " "
"Non-profit"	2,967	42.44 " "

These "non-profit" hospitals are the *same* as those to which the conference committee report refers as "hospitals not operated for profit". This "non-profit" group is stated in the Census Bureau report to be composed of "church, *fraternal* or other *association controlled* institutions". The latter two are important components of the "non-profit" group.

Congress well knew (a) of the various classes of nonprofit hospitals, that is, of the existence of "fraternal" and other "association controlled" hospitals, (scarcely any congressional district but has one or several of them); (b) that these included railroad, mining, lumbering, steel and many other large employee groups, (railroad hospitals, alone, must have well over half a million members), which are all nonprofit, and (c) that these "fraternal" and "association controlled" hospitals are maintained for, and largely supported by, *dues-paying* members, who, thereby become entitled to treatment.

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*"Vital Statistics—Special Reports, Hospitals and Other Institutional Facilities and Services, 1939" Vol. 13, No. 2, p. 7.

Indeed, in many of the smaller communities, there will be only the fraternal or organization controlled hospital, where, however, non-members also are treated. Congress could not have intended that they could treat nonmembers only at the risk of thenceforth being held to be "operated for profit". In *Bedford v. Colorado Fuel & Iron Corp.,* 102 Colo. 538, 81 Pac. (2d) 752, though non-members were charged more than members, the nonprofit hospital was held charitable and exempt from taxation.

Congress has not distinguished between the various classes of nonprofit hospitals, ("church, fraternal, or other association controlled institutions"). All were treated alike. *All* were exempted, and not merely *some* of them. The exclusion was not restricted to "free", or "charitable", or "non-member", hospitals. The test is, "operated for *profit*". What Congress did *not* wish to exempt were the 2,295 "proprietary" hospitals.

The government cannot point out *which* of these 2,967 "nonprofit" hospitals shall be held not to be such, nor what principle of differentiation shall apply, nor the difference between appellee and other "fraternal" or "institution controlled" hospitals. The exemption cannot be narrowed down to "church" hospitals, for nearly all their patients usually pay for treatment.

The House and Senate reports (Brief for Appellee, pp. 10-12) show, also, that a large part of all workers

(9,389,000 out of 37,743,000) were to be *"excluded"*, and that such exclusion was to embrace *"institutional* workers". Appellee is an "institution".

The opinion, we submit, violates the settled principle that exemption is not lost by using income, *from whatever source,* to *further the purposes* which are made the basis for the exemption. This error appears from the committee reports and is further shown by numerous decisions. The committee reports expressly sanction operations for *profit.* What is to control is the *use* or *destination* of any income so earned. As twice stated in each report, (Brief for Appellee, p. 12):

> "For the purpose of determining whether such an organization is exempt, the USE *to which the net income is applied is the ultimate test of the exemption rather than the* SOURCE *from which the income is derived."*

Similarly, in *Trinidad v. Sagrada Orden,* 263 U. S. 581, 68 L. Ed. 458, 44 S. Ct. 204:

> "First, it recognizes that a corporation may be organized and operated exclusively for religious, charitable, scientific or educational purposes, *and yet have a net income.* Next, it says nothing about the *source* of the income, but makes the *destination* the ultimate test of exemption." (Emphasis ours.)

As said in *Commissioner v. Kensico Cemetery,* 2d Circ., 96 Fed. (2d) 594, 596, "the cemetery's revenues were *devoted to the purposes* for which the statute desires them to be exempt", that is, "to a

public purpose *which the tax law aims to protect.*" (emphasis ours)

Again, in *Koon Kreek Klub v. Thomas,* 5th Circ., 108 Fed. (2d) 616, 618:

> "The exemption applies to profits so long as they are retained by the organization or used to *further the purposes which are made the basis of the exemption,* and are *not otherwise* used for the benefit of any private shareholder." (emphasis ours)

In *United States v. Proprietors of Social Law Library,* 1st Circ., 102 Fed. (2d) 481, 484, the library was held exempt although its net earnings enabled it to do better work, whereby it was made more serviceable to its members, and notwithstanding that this "*resulted in distributing its benefits among private shareholders or individuals.*"

In this respect, no distinction, we submit, exists between earnings from rents or investments or from the use of surplus facilities, that is, income from non-member patients. Indeed, their treatment is strictly a *hospital* "purpose". By treating non-members, appellee did not "enter" a new "field". As said in *Commissioner v. Chicago Graphic Arts Federation,* 7th Circ. 128 Fed. (2d) 444:

> "Any business in which respondent has engaged of a kind *ordinarily* carried on was only *incidental* or *subordinate* to its main or primary *purpose.*" (emphasis ours.)

But even were it otherwise, this would be immaterial. In *Roche's Beach, Inc. v. Commissioner,* 2d

Circ., 96 Fed. 776, income not ancillary or incidental, but earned by the incorporated business subsidiary of a charitable testamentary foundation, was held exempt.

The act seeks to encourage *non*-pecuniary benefits, that is, the treatment of the sick without profit, especially of a large group whose membership is unlimited. Congress sought to *favor* nonprofit hospitals because of their benefit to the entire community. And the imposition of the tax upon appellee is subversive of this public policy. To deny exemption where income, from whatever source, is applied to promote the health of a large part of the community, nullifies the intention of Congress.

The act forbids that net income shall inure, in a pecuniary sense, to the benefit of any *"private"* shareholder or individual, that is, to the *"private"* pecuniary benefit of one or more members of the group, as distinguished from the benefits to the group as a whole. To hold that "private" applies to *each* member of a group of *ten thousand* persons ignores the meaning of language and abolishes the distinction between the group and those members thereof who are "privately" benefited, that is, who receive a benefit *peculiar* to themselves. "Private" gain defeats the exemption. Were appellee's membership to increase to twenty, thirty, or fifty thousand, would it still be said that net income from non-member patients inured to the "private" advantage of *each*

member? And if not, ten thousand members are enough.

"*Private pecuniary profit and gain* is the test to be applied," *Kemper Military Academy v. Crutchley,* 274 Fed. 125. Appellee's members, however, have no *proprietary* right in its assets, but only one to treatment, (10 Corp. Jur. Secun. 297).

The added benefits to appellee's members from augmented earnings, *from whatever source derived, is the very purpose upon which the exemption of nonprofit hospitals is founded.* Even had Congress erred in treating nonprofit hospitals as "charitable" institutions—though its view is upheld by numerous decisions—its determination is none the less binding upon the courts. Congress was competent to say, (as in *Ould v. Washington Hospital,* 95 U.S. 303, 311), that charity refers to "almost anything that tends to promote the well-doing and well-being of social man."

As we have shown, the Act must be read as if it exempted, *in terms,* corporations organized and operated for "religious * * * *or hospital* purposes." This clause does not deal either with the *source* or *destination* of its revenues, but designates the *purposes* only. "Exclusively" refers only to these primary *purposes* for which the corporation is formed, that is, its *objects* or *ends,* and *not* the *means* by which such "purpose" is accomplished.

For convenience, Sections 811(b)(8) and 907(c)(7) of the Security Act are set forth:

> "Service performed in the employ of a corporation, community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational *purposes,* or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any *private* shareholder or individual."

The concluding clause, "no part * * * ", does not define or qualify "charitable" in the first clause. It also appears (Int. Rev. Code Sec. 101(5)(7)(8)(9)) in relation to cemetery companies, business leagues, clubs, board of trade, and the like. In substance, it means "not for private gain". As said in *Mertens Law of Federal Income Taxation,* Vol. 6, Sec. 34.18, p. 29, this clause "is independent of the other tests, it operates regardless of the fact that the purposes may be religious, educational or literary."

Nor does appellee benefit at the "expense" of outsiders. The latter pay only the current prevailing rates for like hospitals in the community, (R. 144).

The public health is one of the gravest concerns of the state, upon which may depend its existence or survival. It is greatly in the public interest that the largest number of persons receive the utmost protection and at the lowest cost. For nonprofit hospitals to reduce their overhead by also caring for nonmembers helps to widen their benefits. *The better*

appellee accomplishes this, the better it justifies and deserves the exemption which Congress intended it to receive.

Appellee's requirements for admission are simple and non-exclusive. Applicants need only be *partly* of French birth, or speak French, the latter requirement being liberally construed, (R. 30, 137). From a few members, appellee's membership has increased to nearly ten thousand. The public interest is directly served by continually extending those benefits to more and more people.

We submit, therefore, that the exemption is not destroyed if, by reason of augmented income—whether from rents, investments or receipts from non-member patients—appellee can better further the *"purposes"* which are made the basis for the exemption. If net income is *not otherwise* used for the benefit of any "private" individual, the "purpose" which the exemption seeks to encourage is fully satisfied.

The opinion, we submit, errs in stating:

> "The Society has cited a number of tort cases holding various types of hospitals charitable and so not liable for the negligence of doctors employed in such hospitals."

In our brief, (pp. II-IV), we had cited thirty-nine decisions holding nonprofit hospitals to be per se charitable institutions. They related to torts and to

charitable gifts, and of them the following *fifteen* dealt specifically with *exemptions from taxation:*

In re Mendelsohn, 262 App. Div. 605, 51 N.Y.S. (2d) 435, 440 (social security tax).

Commissioner of Internal Revenue v. Battlecreek, Inc., 126 Fed. (2d) 405, (income tax).

In re Rust's Estate, 168 Wash. 344, 12 Pac. (2d) 396, 398 (1932).

New England Sanitarium v. Inhabitants of Stoneham, 205 Mass. 335, 91 N. E. 385, 387, (1910).

People v. Sexton, 267 App. Div. 736, 48 N. Y. Supp. (2d) 201.

Scripps Memorial Hospital v. California Employment Commission, 24 Cal. (2d) 669, 151 Pac. (2d) 109, (social security tax).

Brattleboro Retreat v. Town of Brattleboro, 106 Vt. 228, 173 A. 209, 212, (1934).

Lutheran Hospital Ass'n v. Baker, 40 S.D. 226, 167 N.W. 148 (1918).

State v. H. Longstreet Taylor Foundation, 198 Minn. 263, 269 N. W. 469 (1936).

German Hospital v. Board of Review, 233 Ill. 246, 84 N. E. 215.

County of Henepin v. Brotherhood of Gethsemane, 27 Minn. 460, 38 A.R. 298.

Bedford v. Colorado Fuel & Iron Corp., 102 Colo. 538, 81 Pac. (2d) 752, 759.

Rush Hospital Benev. Ass'n v. Board of Sup'rs., 187 Miss. 204, 192 So. 829 (1940).

Piedmont Memorial Hospital v. Guilford County, 218 N.C. 673, 12 S.E. (2d) 265.

Virginia Mason Hospital v. Larson, 9 Wash. (2d) 284, 114 Pac. (2d) 976, (social security tax).

Nonprofit hospitals have long been held charitable. As said by Mr. Justice Cardozo in *Butterworth v. Keeler,* 219 N.Y. 446, 114 N.E. 803, nonprofit "universities and hospitals are unquestionably public charities", and by L. Hand, J., in *Slee v. Commissioner,* 42 Fed. (2d) 184, "to maintain health without profit * * * has been a recognized form of charity from time immemorial." It was competent for Congress to take the same view. See:

Buchanan v. Kennard, 234 Mo. 117, 139, 136 S. W. 415, Ann. Cas. 1912D 50, involving a devise in trust to maintain a hospital not restricted to the poor, the court holding the relief of the sick, rich or poor, to be a charitable purpose.

The opinion states that, in 1944, receipts exceeded disbursements by nearly $70,000 and that sixty-seven per cent of the total income in that year was from non-members. Normally member-patients far outnumber non-members, (Plff. Exh. 10, R.168). However, in the seven years ending February 28, 1943, disbursements exceeded receipts by $105,134.08. In the eight years ending February 29, 1944, they exceeded receipts by $35,283.96, (R. 156), and in that period appellee's surplus account decreased, by $65,682.95, to $70,642.70,

(R.80). In the same period, permanent improvements, semi-permanent improvements and maintenance amounted to about $125,000, (R. 83, Plff. Exh. 4). Briefly, during these eight years there was *no "net income"* which could have enured in the "private" benefit of any one.

Moreover, excess in receipts over disbursements in 1944 was *temporary,* because appellee's hospital, like all others, is fully occupied during the emergency. When receipts return to normal, wages and other expenses will probably continue *permanently* higher. The 1944 "profit" will prove to have been worse than illusory.

The donations and bequests have aggregated $362,822.63, (R. 81). In the past thirty years, appellee's average annual income from interest, rents and dividends has been from $7,000 to $10,000, practically all being income from such gifts and donations, (R. 85). What is certain is, that after deducting these gifts and the increment therefrom, its assets, in the period of ninety-three years, have increased at an annual rate of less than five thousand dollars, and that such assets consist only of its hospital property and of moderate reserves essential to its continued existence. Everything has gone to the protection of health.

By the 1939 change in ruling, appellee was required to pay an additional $13,550.56, represented by:

Employees' tax, (Title VIII) paid by appellee from its own funds and not repaid to it..... $6,195.77

Penalties (under Title IX)..... 976.51

Penalties (under Title VIII).....	4,019.84
Interest (under Title IX).....	404.13
Interest (under Title VIII).....	1,954.61

This $13,550.56, with the employer's tax under Title VIII, ($15,785.57), and its tax under Title IX, ($5,933.72), represents the $35,269.85 for which appellee recovered judgment. Interest and taxes, then, added *more than sixty per cent* to its *own* obligation. The claims for refund also rely on this change in ruling, (R. 20).

Under such circumstances, courts make every effort to find means to correct flagrant injustice, (*Bull v. United States,* 295 U. S. 247, 79 L. Ed. 421, 55 S. Ct. 695).

The cases referred to in the opinion are not, we submit, to the contrary. In the first place, they refer to the taxpayer's *own* obligation.* Here, liability for employee's tax was to be borne by *them*. The employer merely *transmits* it to the fund. Congress never intended that the employer should pay it. After the 1937 ruling, however, appellee had no discretion but to pay wages without deduction, for non-payment would have been a misdemeanor, (Cal. Labor Code, Sec. 216).

Any court would hesitate to say that there can *never* be an estoppel against the government. There

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*In one of them, (*National Rifle Association v. Young,* 134 Fed. (2d) 524), it is said that

> "Since there is no showing that appellant changed its position or was in any way injured by reason of the Social Security's earlier ruling there is no basis for a claim of estoppel."

are cases to the contrary, (*Mertens, Law of Federal Income Taxation* (1943), Vol. 10, Sec. 60.13, p. 636), and hence the state court found no difficulty in this respect, (Brief for appellee, p. 7). If an estoppel *ever* can arise, it could never be more justly than here. That appellee, though wholly without fault, should still be required to pay penalties of $4,996.05, offends the moral sense.

In the next place, appellee's right to redress is not restricted to estoppel. I.R.C. Sec. 3612(d) provides for a twenty-five per cent penalty for failure to file a return.

> "Except that when a return is filed after such time and it is shown that the failure to file it *was due to a reasonable cause and not to wilful neglect, no such addition shall be made to the tax.*"

and section 3655(b) for an additional penalty of five per cent for non-payment after demand by the collector.

Furthermore, Section 3791(b) authorizes the Commissioner, with the approval of the Secretary, to prescribe the extent, if any, to which any ruling relating to the internal revenue laws shall be applied without retroactive effect. This, of itself, recognizes that the government's right to the tax was not intended to be made absolute, but to be within the Commissioner's discretion, the abuse of which the courts are not powerless to remedy. They have frequently disapproved his regulations, (*Mertens,* op. cit., Vol. 9, Sec.

49.18, p. 176, Sec. 35.68), where not reasonable or not in furtherance of the congressional intent. Also, the Commissioner may refund *penalties* collected without authority, and all taxes "in any manner wrongfully collected" (Id)3770(a)(1).

Congress never intended to *penalize* a "taxpayer" who, though ready to pay, was told by the commissioner that no tax was due and that none could be accepted. In *Fromm Bros. Inc. v. United States,* 35 Fed. Supp. 145, 148, where taxpayer was advised by its attorney that it was exempt from social security tax, it was held that "the Commissioner's assessment and collection of penalties for delinquency and for alleged wilful failure to file the return was unwarranted."

Ordinarily, tender stops interest. None could be made where the assumed "creditor" states that there is *no* debt and that he will not accept payment. In the absence of contract, interest is *awarded as damages* on the theory of *wrongful* detention, (33 Corp. Jur. 178), that is, after *default.* The rule in equity is that the allowance or denial of interest is in the court's sound discretion, (33 Corp. Jur. 182). In *Richardson v. Louisville Banking Co.,* 5th Circ., 94 Fed. 442, 449, though judgment was rendered against a receiver, it was held interest should not be charged against him for "refusing to recognize complainant's demands, until they were judicially determined."

CONCLUSION.

In conclusion, we submit that appellee is a hospital "not operated for profit" and, as such, a charitable corporation within the meaning of the relevant sections of the Social Security Act; that its exclusive purpose is, and always has been, charitable, that is, the treatment of the sick without profit; that, even in the absence of the unmistakable indication furnished by the conference committee report, a nonprofit hospital is, *per se,* a charitable institution, and that what governs is the use of the income, and not the source from which it is derived.

Moreover, the Commissioner further erred in requiring appellee to pay the employees' contributions which had accrued before the change in ruling in 1939, and interest and penalties, and in denying its claims for the refund thereof.

It is respectfully submitted that a rehearing should be granted.

Dated, San Francisco, California,
December 28, 1945.

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Attorneys for Appellee and Petitioner.

Certificate of Counsel.

The undersigned, P. A. Bergerot and A. P. Dessouslavy, hereby certify that in their judgment the foregoing petition is well founded and that it is not interposed for delay.

Dated, San Francisco, California,
December 28, 1945.

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